Please note that the commentary is for the retail class of the Fund.

What initially appeared like the foundations of a broad-based recovery across financial markets in the first part of the third quarter (Q3-22) ultimately turned to dust. The initial basis for the widely experienced rebound in risk assets, after the sharp declines in the first half of 2022, was an emergent belief that the very worst surge in inflation was behind us. This took hold most persuasively in the US where a combination of modestly improved inflation data and a willingness of financial markets to emphasise the more dovish elements of the Federal Reserve (the Fed)'s commentary elevated the expectation that the end of FOMC tightening was in sight and that monetary loosening was foreseeable in 2023. The factor that initially tempered the recovery of cyclical assets was push-back from the Fed itself. Clearly the members of the FOMC became concerned about the overly enthusiastic interpretation by financial markets of the Fed's risk assessment around a potential peak in inflation and what this might imply for the course of monetary tightening in the quarters ahead. And this rectifying communications broadside built up sizeable momentum, culminating in comments from Fed Chairman Jerome Powell at the central bank's annual symposium in Jackson Hole, which spelt out in unambiguous terms how inappropriately dovish market pricing of rate hikes in the US had become.

If this wasn't enough, an unexpectedly sharp turnaround in inflation measures for August cemented the case that market expectations for the scope and scale of the Fed's tightening cycle had become hopelessly too optimistic. Shortly after, the Fed delivered a third consecutive 75 basis points (bps) rate hike and signaled the favoured potential for at least another 100bps over the remainder of the year, with more upside than downside, as well as an extended period of an elevated policy rate over the course of 2023. With the double hit from an evaporation of the mid-year inflation softening and the Fed's much more assertive stance outlining their willingness to crimp growth in order to bring inflation back to heel, the nascent recuperation in asset prices was swiftly reversed and added to in the second half of Q3-22.

This temporary rebound in risk assets during the first part of Q3-22 was largely incited by US developments. However, there were also clear parallels in other major markets around overly hopeful monetary policy expectations having to be restruck to more realistic profiles – and with commensurate adjustments to cyclical and interest-rate sensitive assets. Indeed, this was most clearly evident in Europe, where prior expectations had been for a well-flagged and mild initiation of the hiking cycle in July. What should have been a 25bps hike was notched up to 50bps, and together with another concerning inflation surge over the quarter, followed up by a 75bps hike in September. But while Europe's woes were a clear analogue to US developments, these were magnified by the extension of the particularly European energy shock seen in the second half of 2022. Gas prices undertook another sizeable acceleration in the quarter, prompting several government initiatives to protect consumers/producers. Undoubtedly helpful, but also complicating, as energy markets become more distorted and fiscal costs weigh on sovereign risk premia and influence monetary policy interventions.

Thus, three interconnected influences moved swiftly to tear down the wide-spread asset price recovery seen at the start of Q3-22: overly benign monetary policy expectations premised off a belief in the worst of inflation having past, coupled with a corrected assumption of markets around central bank willingness to enforce a slow-down in growth. Indeed, fears around internally-driven recessions within 12 to 24 months took a leap-step upwards across most major economies over the course of the quarter.

With the combination of these particular influences, it was hardly surprising to see listed property come under especially severe pressure. Indeed, while the initial recovery across real estate sectors moved in lockstep with their broader equity counterparts, when the retraction came, this was exaggerated within property to a substantive degree. Weakness in listed real estate was experienced across geographies and sectors – there were no real exceptions over the quarter although, notably, Japan was the, relatively, least impacted. European counters were especially hard-hit. Here, the impact of enhanced recession fears, higher energy costs and a re-setting of interest rate expectations, together with an aggressive start to the European Central Bank's tightening programme, proved a formidable combination. The focal point for investors was balance sheet vulnerability. With funding costs rising unexpectedly rapidly and medium-term interest rate expectations migrating higher, those entities with shorter debt profiles, higher gearing, mis-matched hedging or any other debt-related fragility were commensurately chastised.

Alongside equities, global credit markets experienced universal negative performances over Q3-22. For the most part, these drawdowns were not quite as draconian as those seen in the first two quarters of 2022. The notable exception was the UK, which was a stand-out among both developed and emerging asset markets over Q3-22. This was mostly a late quarter development, as the UK was roiled in the wake of the 'mini-budget' event presented by the new Chancellor. With significant tax cuts funded by new borrowing, on the eve of the Bank of England's pivot with its own government debt holdings, the market response was one of shock and fear. Sterling, gilts and corporate bonds all came under severe pressure, meaning there was no safe refuge within GBP markets.

Across the quality spectrum in credit markets, Q3-22 proved more of a struggle for investment-grade (IG) bonds. Here, longer duration assets and the sharp move in base rates across yield curves in major corporate credit markets meant larger total return drawdowns than those seen in lower quality credits. High-yield (HY) markets, with less overall sensitivity to base rate moves and particularly extended spreads to start the quarter, actually held up reasonably well, even if all major indices still ended in the red on aggregate.

Sovereign debt markets had another poor quarter. Among major Developed Market (DM) government bond markets, only Canada managed to eke out a positive total return for Q3-22 – and at +0.1%, this was barely significant. Next most resilient were the Australian and Japanese sovereign debt markets, which only saw modest (sub-1%) negative performances. European markets were harder hit (c. between -4-5% down), although not much differentiation made across continental names, with the exception of Italy. Here, the combination of a resurgence of ever-present fiscal concerns and increased political flux has led the market to require an even wider country risk spread over German bunds. Over the course of last year, the relative spread pick-up between Italy over Germany tended to hover around 100bps (for the 10-year area). This reached new highs around 250bps during Q3-22 and has remained elevated since.

Within Emerging Markets (EM), a much more diverse set of performances across sovereign bond markets was seen in Q3-22 relative to the broad declines seen across DMs. In local currency terms, the best performer within major EMs came from Brazil, with a gain of 5.2% (excluding Turkey, which jumped c.33% in lira terms). Elevated starting yield levels, as well as some evidence that the peak in Brazilian inflation has actually been achieved – alongside a pro-active and assertive interest rate hiking cycle – has allowed for longer-dated Brazil bonds to outperform. At the other end of the scale, Hungary was the clear laggard among major EMs with a decline of -7.5% for the quarter. A combination of exceptionally elevated inflation, a particularly high reliance on Russian energy imports, a (re)turn to unorthodoxy by the central bank and further political conflict with the EU has paid a heavy toll on both the forint and Hungarian asset prices quite broadly.

However, once exchange rate movements are taken into account, the third quarter was another tough period for performances in EM bonds, once measured in US dollars. For the asset class as a whole, Q3-22 saw a decline of -4.7% for an unhedged holding measured in US dollars. Only two markets achieved positive returns: Brazil and the Dominican Republic (excluding Turkey again). The worst performers were Hungary (-18.7%), Colombia (-12.1%) and the Philippines (-10.8%).

Within hard currency denominated EM sovereign bonds, a similar story unfolded. The overall asset class fell by 4.6%, with very few positive performances on an individual country basis. By region, all major indices were down on the period, with Asia being the worst performer at -6%. On a credit quality basis, there was a mixed bag, with the best performing rating bucket actually being BBs, which only declined -1.8%. The lowest quality bucket (CCCs) fell a substantial -8.8%, which was noteworthy considering the already beaten-up levels the poorest rated EMs had already been taken to in the first half of the year. Indeed, among this group, fiscal distress is only increasing and the potential for additional debt restructuring exercises among the most fragile EM borrowers grew palpably between June and September.

Fund positioning

Fund activity across the quarter was characterised by de-risking into the recovery seen across risk assets during July and the first part of August. From a duration standpoint, the Fund did regulate its aggregate exposure here modestly over the course of the quarter, although the net change from start to finish was relatively small. However, from a credit duration perspective, the Fund took the opportunity to de-risk into the relative stability seen in corporate credit yields seen in the wake of the June sell-off. The net result was that overall credit risk within the portfolio was reduced through a combination of recycling maturities/tenders into cash/risk-free instruments, net corporate credit selling and not offsetting natural duration shortening. In addition to the reduction in credit risk within the portfolio, net property exposure also declined from levels that had already been trimmed earlier in the year.

But, as is usual, the bulk of the Fund's activities related to recycling of existing exposures that had drifted into modestly expensive territory to be replaced by new issues that were perceived to be relatively cheaply priced. Within the EUR market, covered bonds were purchased, including Bank of Montreal, Bank of Canada and Toronto Dominion. These were trading at distinctly wider spreads than was fundamentally justified and their addition also served to enhance the overall credit quality within the portfolio (all issues AAA-rated). At the other end of the scale, the Fund also added a small tranche of a BP hybrid issue. Within the GBP market, the Fund saw several maturities within this space over the quarter. However, with the market turmoil within the UK towards the end of September, opportunity presented itself to accumulate UK exposure. This was initially spearheaded by a generic placeholder purchase of broad UK corporate exposure (through a credit ETF), but then supplemented with additions of VW and Rabobank issues.

Furthermore, the Fund also added UK property exposure through purchases of Land Securities, British Land and Derwent. These are particularly high-quality UK real estate exposures – all with sound balance sheet resilience – which were caught up in the generalised shock to hit UK financial markets in the tail of Q3-22. While the immediate outlook for the UK economy has justifiably been reset lower as a result of higher inflation, higher interest rates and a weaker currency, valuations for the longer-term for what remain some of the best of the UK's listed property sector were too compelling to pass by. Thus, even as the outlook for at least the rest of the year is particularly grim, on a multi-quarter basis these deep-value additions are expected to be fruitful, despite being diminutively sized.

Other fund activity of particular note rested with its EM exposure. Here, holdings of long-dated SAGBs were trimmed in a fortunately very timely way – essentially at the very peak of their early August surge into strength. In terms of additions, the Fund participated in a primary auction of a new Mexican three-year deal, denominated in Japanese yen. The combination of the cross-currency basis and weakness in EM sovereign spreads made for an attractive addition to the Fund when this was hedged back into USD.

The outlook for the remainder of the year and beyond continues to be fraught. While the re-pricing of base rates and expectations for additional core market monetary policy tightening has taken a sizeable leg upwards in the past three months, these levels may stay elevated for an extended period. In addition, the reversal of what appeared to be a fading inflation surge during Q3-22 has revived concerns around much more persistent second-round effects over 2023 and beyond, across practically all jurisdictions to a greater or lesser degree.

Indeed, with necessarily revitalised aggression shown by most of the core central banks in recent months, the corresponding potential for more severe slowdowns across much of the globe's growth centres has scaled upwards accordingly. And while there isn't especially persuasive evidence that wage-price spirals have taken hold assertively in any major economy, it is far too early for any central bank to definitively claim victory here either. Hence, the potential for further front-loading rate hikes in an emphatic manner is what likely lies ahead in the next couple of quarters.

Outlook

The Fund recognises the tension between a stagflationary outlook and asset prices that already acknowledge this potential environment. As such, where specific cases of asset price weakness have become exaggerated, the Fund retains both the appetite and ability to continue accumulating these exposures. But this needs to be executed in a judicious manner. For particularly cyclically-exposed entities, the very worst economic outcomes are only partially priced – deep recessions within either the US or Europe would still manifest themselves very painfully across many risk assets, if to arise. As such, and given the attractive outright yield already produced by the portfolio, the Fund retains sufficient flexibility to accumulate additional risk in the event of further weakness in the months ahead. Indeed, this capacity was fortunately replenished during the first part of Q3-22 and only utilised sparingly to date. This is available across all the primary risk buckets available to the Fund and provides a favourable base to set the Fund up for the ensuing phases of the cycle to come.

Portfolio managers
Nishan Maharaj and Seamus Vasey
as at 30 September 2022